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UNITED STATES BANKRUPTCY COURT

NORTHERN DISTRICT OF CALIFORNIA

In re DIANE KIESNOWSKI, Debtor.	Case No. 99-33223-SFM Chapter 7

MEMORANDUM DECISION

I. INTRODUCTION

In this case, the family of debtor Diane Kiesnowski ("Debtor"), being concerned that money they set aside for her retirement be there when she needed it, attempted to establish Individual Retirement Accounts ("IRAs") for her benefit. Their motives were both to keep those accounts secret from Debtor, so that she would not make early withdrawals, and to provide a tax shelter for the earnings on those accounts. Now that Debtor is in bankruptcy, she (and her family) want to insulate those accounts from the claims of her creditors through the Chapter 7 trustee.

The court is required to balance strong bankruptcy policies – liberal construction of exemptions and the need to provide Debtor with a fresh start – against the technical requirements of tax laws. Debtor’s family could have established a valid spendthrift trust for her benefit.[1] Such a trust would have insulated virtually all of the res of that trust from creditors and prevented Debtor from making early withdrawals.[2] Such a trust might not have had the intended tax benefits, but would have provided the creditor protection now sought. Alternatively, Debtor’s family might have given Debtor annual gifts enabling her to make qualifying contributions to her own IRAs. Such IRAs would have had the intended tax advantages and protection from creditors. Rather than choose between these alternatives, Debtor’s family attempted to meld the advantages of both by setting up and funding IRAs without Debtor’s knowledge. However, that attempt did not comply with the tax laws, and therefore this court must deny Debtor most of her claimed exemption.

II. FACTS[3]

Debtor claims an exemption under California Code of Civil

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[1] Californa Probate Code § 15301 permits a trust instrument to provide that a beneficiary’s interest in the principal is not subject to voluntary or involuntary transfer, nor subject to enforcement of a money judgment until paid to the beneficiary.

[2] California Probate Code § 15306.5 limits the scope of a spendthrift trust such that a judgment creditor may seek up to 25% of the funds otherwise available to the beneficiary, but reserving for the beneficiary amounts necessary for the support of the beneficiary and others.

[3] The following discussion constitutes the court’s findings of fact and conclusions of law. Fed. R. Bankr. P. 7052(a).

Procedure ("CCP")[4] Section 703.140(b)(10)(E) for two IRAs valued at $54,079.00 as of the date Debtor filed her bankruptcy petition. The first account was opened with a deposit of $2,000.00 on April 19, 1993, with the Vanguard Fiduciary Trust Company ("Vanguard"), account number 09886365889 ("Vanguard I"). There were no other deposits to Vanguard I. The second account was opened with a deposit of $12,437.90 on April 21, 1994, also with Vanguard, account number 09091361736 ("Vanguard II"). The source of this initial deposit was an earlier account with Home Savings of America, F.S.B., account number 32-730763-3 (the "Home Savings Account").

Debtor's mother, Norma Kiesnowski, established each of these accounts for Debtor, intending them to qualify as IRAs. For several years she and Debtor's father and grandparents contributed no more than $2,000.00 per year to these accounts, while keeping them secret from Debtor. Debtor's family was concerned that if Debtor knew about the IRAs she might withdraw and spend the funds.

Debtor was earning income at the time of all the contributions to these accounts. In fact, after Debtor found out about the accounts she made her own contributions to Vanguard II amounting to $2,000.00 – $1,000.00 in April of 1995 and 1996 for tax years 1994 and 1995.

Debtor alleges that in the late 1970's and early 1980's, while working at the Emporium Department Stores, she contributed to an account that was either an IRA or a pension plan qualified

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[4] California has "opted out" of the federal exemption scheme, so California law governs whether debtor's accounts are exempt. See Cal. Code Civ. Pro. § 703.130; Turner v. Marshack (In re Turner), 186 B.R. 108, 113 (9th Cir. BAP 1995).

under 26 U.S.C. Section 401(k) (the “Emporium Account”), and that the Emporium Account was “rolled over” into Vanguard II. However, the only evidence produced by Debtor to corroborate the allegation that the Emporium Account existed or was rolled over into Vanguard II was a letter from Debtor’s own counsel. At the trial of this matter, on November 9, 2000, the court disregarded Debtor’s evidence as not credible, based upon Debtor’s own misinformation and her thus inaccurate statements to her counsel.

III. PROCEDURAL HISTORY

Debtor filed her voluntary chapter 7 petition on October 5, 1999. On November 19, 1999, the chapter 7 trustee, E. Lynn Schoenmann (the “Trustee”), filed an objection to Debtor’s claimed Schedule C exemption of $54,079.00 in an “IRA - The Vanguard Group (500 Index Fund)” under CCP § 703.140(b)(10)(E). The Trustee asserted that the IRAs were not exempt because they failed to qualify under applicable provisions of the Internal Revenue Code (the “Revenue Code”), 26, U.S.C. Section 401 et seq.[5]

On August 21, 2000, Debtor filed her second amended Schedules B and C, which listed the same IRA and added a $12,000.00 portion of her “wildcard” exemption under CCP § 703.140(b)(1) and (5) “to exempt any funds ... that may not be exempt under [CCP § 703.140(b)(10)(E)].” The Trustee has not objected to the wildcard exemption.

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[5] As the United States Tax Court has noted, the statutes, regulations and related cases are somewhat flexible in their terminology: they use terms like “qualified” and “exempt” synonymously, and “unqualified” and “nonexempt” synonymously. Fazi v. C.I.R., 102 T.C. 695, 715 n.3 (U.S. Tax Ct. 1994). For convenience, this Memorandum Decision uses grammatical variants, such as “non-qualifying,” although though that term is not used in the applicable statutes and regulations.

After trial the parties were directed to submit post-trial briefs on whether establishing and funding the IRAs without Debtor’s knowledge disqualifies those accounts under applicable provisions of the Revenue Code. The parties did so, and the matter was submitted on December 18, 2000.

IV. DISCUSSION

Under CCP Section 703.140:

> (b) The following exemptions may be elected as provided in subdivision (a):
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> * * *
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> (10) The debtor’s right to receive any of the following:
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> * * *
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> (E) A payment[[6]] under a stock bonus, pension, profit-sharing, annuity, or similar plan or contract on account of illness, disability, death, age, or length of service, to the extent reasonably necessary for the support of the debtor and any dependent of the debtor ....

The parties agree that if Debtor’s accounts qualify as IRAs then they will be exempt. Farrar v. McKown (In re McKown), 203 F.3d 1188 (9th Cir. 2000); Rawlinson v. Kendall (In re Rawlinson), 209 B.R. 501, 502 (9th Cir. BAP 1997).[7]

1. Burden of Proof

Federal Rule of Bankruptcy Procedure 4003(c) places the burden on the party objecting to a claimed exemption to show, by a

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[6] The statute’s exemption of a right to receive a “payment” has been interpreted to mean that the entire IRA account is exempt. Rawlinson v. Kendall (In re Rawlinson), 209 B.R. 501, 505-506 (9th Cir. BAP 1997).

[7] IRAs are can also be exempted under California’s alternative bankruptcy exemptions, CCP § 704.115(a)(3). In re Mooney, 248 B.R. 391, 396-400 (Bankr. C.D. Cal. 2000).

preponderance of the evidence, that the debtor is not entitled to the exemptions claimed. However, this burden may be qualified in two respects. First, some courts place the burden on the debtor to show that the claimed exemption is within the type of property exempted by the statute. See In re Gregoire, 210 B.R. 432, 436 (Bankr. D. R.I. 1997) (initial burden is with debtor to establish that exemption "is of the type covered by the statute."). Contra In re Ciotta, 222 B.R. 626, 629 (Bankr. C.D. Cal. 1998) ("Gregoire unwisely reallocates the burden prescribed by Rule 4003(c) and reverses the presumptive validity of the scheduled exemption."). Cf. In re Mohring, 142 B.R. 389 (Bankr. E.D. Cal. 1992), aff'd 153 B.R. 601 (9th Cir. BAP 1993) (table), aff'd 24 F.3d 247 (9th Cir. 1994) (table) (debtor's claim of exemption not sufficiently specific to enable court to determine whether it came within statute).

Second, once the objector has made a prima facie showing that debtor's claimed exemptions should be disallowed, the burden shifts to the debtor to prove that the exemptions are legally valid. In re Wilbur, 206 B.R. 1002, 1006 (Bankr. M.D. Fla. 1997); In re Pettit, 224 B.R. 834, 840 (Bankr. M.D. Fla. 1998).[8]

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[8] The Pettit court sustained an objection to part of the debtor's claimed exemption in a retirement account because there was "no evidence" that the source of contributions was expense reimbursement and therefore within a Florida statute exempting "earnings" or "wages." Pettit, 224 B.R. at 840. However, the Pettit court also overruled an objection to another retirement account because the objecting party failed to show that a valid trust agreement did not exist:

> The objecting party has not proven by a preponderance of the evidence that [the debtor's] Prudential Securities Account does not qualify as

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These general principles are easy to state but potentially difficult to apply. If the initial burden is on the debtor to show that an alleged IRA account was properly set up and funded, how far back must the debtor go? For example, if the source of funds is important would a 60-year-old debtor be required to provide evidence of the source of funds in an IRA established 30 years earlier and rolled over many times? On the other hand, would a trustee be required to prove a negative – that funds contributed to an IRA 30 years ago did not come from wages, if that is what the law requires? The burden might shift – and the degree of proof might vary – with factors such as how far back the trustee wishes to look and the nature of the entity or person administering or contributing to the IRA. However, the court need not decide these issues because Debtor admitted that her family set up and funded substantial portions of her Vanguard accounts. In other words, if the source of funds is important as a matter of law then under any standard the Trustee has met her initial burden

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[8](...continued)

> an IRA pursuant to § 408, and consequently, that it is not exempt pursuant to § 222.21(a) [Florida Statutes Annotated]. [The objecting party] is correct in his contention that the documents in evidence do not comply with § 408 of the Internal Revenue Code. However, he has not proven that any of the documents in evidence is the trust instrument, or alternatively, that a trust instrument that complies with § 408 of the Internal Revenue Code does not exist. Because [the objecting party] has not met <u>his burden</u> as to the IRA/SEP exemption, the objection must be overruled and the exemption allowed.

<u>Pettit</u> at 842 (emphasis added). <u>See also</u> <u>In re Groff</u>, 234 B.R. 153, 156-157 (Bankr. M.D. Fla. 1999) (trustee failed to meet burden to prove that retirement plan sponsor failed to adopt prototype plan amendment).

and the burden has shifted to Debtor to show a proper source of funds. Debtor has met that burden with respect to the $2,000.00 that was contributed from her wages. As for the remainder, the court turns to the legal issue whether Debtor's family could fund her IRA.

2. Debtors' Family Could Not Make Qualified Contributions to IRAs for Debtor

Section 408 of the Revenue Code, 26 U.S.C. § 408, which defines IRAs, refers to contributions "on behalf of" an individual, which could be read to suggest that anyone may make a contribution for someone else. However, another interpretation is that Congress used this terminology solely because some persons are explicitly authorized to contribute on behalf of an individual, such as employers who make contributions for employees. Given this ambiguity the parties, and the court, look to other parts of the statutory scheme to determine Congress' intent.[9]

The Trustee argues that Revenue Code Section 408(i) requires notices to IRA beneficiaries, and that this eliminates the possibility of an IRA established and maintained without the beneficiary's knowledge. However, the notice requirement is

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[9] The regulations state that an IRA "may be established and maintained by an individual, by an employer for the benefit of his employees ..., or by an employee association for the benefit of its members ...." 26 C.F.R. § 1.408-2(a) (emphasis added). The "individual" could mean the future retiree (Debtor) and nobody else, but that reading is arguably too narrow because it would conflict with other regulations that effectively allow spouses to contribute to and have interests in each other's IRAs. See 26 C.F.R. § 1.219-1(c)(3) (rules for contributions by one spouse for account of other spouse); 26 C.F.R. § 1.408-2(b)(7) and (8) (definition of beneficiaries, and distribution on death of taxpayer).

intended to protect the beneficiary by assuring accountability, not penalize the beneficiary by disqualifying the IRA if there is no notice. See Investment Co. Institute v. Conover, 596 F.Supp. 1496, 1502 (D. D.C. 1984) (§ 408(i) reporting requirements are among the investor protections that justified ruling by Comptroller of the Currency that banks could establish collective investment trusts for IRAs without violating Glass-Steagall Banking Act's separation of banking and securities functions), aff'd, 790 F.2d 925 (D.C. Cir. 1986), cert. denied sub nom Investment Co. Institute v. Clarke, 479 U.S. 939, 107 S.Ct. 421, 93 L.Ed.2d 372 (1986).

Debtor argues that permitting IRAs to be established and funded without the beneficiary's knowledge is consistent with the purpose of CCP Section 703.140 et seq., which she claims is to "safeguard a stream of income for retirees at the expense of bankruptcy creditors." Jacoway v. Wolf (In re Jacoway), 255 B.R. 234, 239 (9th Cir. BAP 2000) (interpreting CCP § 704.115), quoting DeMassa v. MacIntyre (In re MacIntyre), 74 F.3d 186, 188 (9th Cir. 1996) (same). Debtor also urges that Jacoway requires the bankruptcy court to look at "all factors." Id.

However, Jacoway concerned an account that was assumed to qualify as an IRA, but that arguably was not a "private retirement plan" under CCP § 704.115 because the debtor therein was allegedly withdrawing funds from the account for non-retirement purposes. Jacoway, 255 B.R. at 238 and n.4. Thus Jacoway assumed the issue that the parties dispute in this case: whether the accounts at issue qualify as IRAs.

Debtor also argues that knowledge of the Home Savings Account and the two Vanguard accounts is imputed to her, because at some point she allegedly gave her mother a power of attorney. The Trustee points out that Debtor and her mother testified only that there used to be a written power of attorney, which was probably destroyed when Debtor graduated from high school, and an oral power of attorney is not valid. See Cal. Probate Code § 4022; Cal. Civ. Code § 2309. See also 26 U.S.C. § 408(a)(1).

Looking beyond Section 408, the Revenue Code and regulations have detailed provisions allowing a contribution by on account of spouses to an account maintained by either of them. See 26 U.S.C. § 219(c), (f)(2) and (g); 26 C.F.R. § 1.219-1(c)(3). These provisions would be unnecessary if any individual could contribute on behalf of any other. Therefore, the court concludes that Debtor's family could not set up and fund IRAs on her behalf, with or without her knowledge. See also D.R. Baker, Tax Management Portfolios, IRAs, SEPs and SIMPLEs (BNA 355-5th, 1999 and 2001) p. A-27 ("Contributions by Persons Other than the IRA Owner") and pp. A-19 - A-21 (spousal IRA contributions) (suggesting by negative implication that only employers, unions, and spouses may establish IRAs for another person).

For the foregoing reasons, Debtor's parents and grandparents could not make qualified contributions to IRAs on Debtor's behalf. The next question is whether that disqualifies the accounts as a whole.

3. The Vanguard Accounts Are Not Disqualified as IRAs by Commingling Contributions From Debtor's Family With Contributions From Debtor or Her Employers

The Trustee claims that an otherwise qualified IRA will become disqualified if it includes funds transferred from a non-qualified plan or source, citing Baetens v. Commissioner, 777 F.2d 1160, 1167 (6th Cir. 1985). The court disagrees with that reading of Baetens and concludes that the contributions from Debtor's family do not disqualify her entire IRA accounts.

In Baetens several taxpayers attempted to roll over funds from employee benefit accounts (the "Old Accounts") to IRA accounts (the "New Accounts"). A rollover is treated as a distribution to the taxpayer but the general rule is that a distribution will not be included in gross income for that year if it is made from a "qualified trust" or IRA and reinvested into a qualified IRA. See Baetens, 777 F.2d at 1162-63, quoting former 26 U.S.C. § 402(a)(5)(A) and (D), and see current 26 U.S.C. § 402(a) and (c)(5) and 26 U.S.C. § 408(d)(1) and (3). The Baetens court held that because the Old Accounts were not "qualified trust[s]" the distribution from them did not qualify for tax-free rollover.[10] However, those Old Accounts were

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[10] Baetens rejected the taxpayer's argument that the distribution could be partially rolled over because a portion of the funds in the Old Accounts had been contributed at a time when the Old Accounts were "qualified trust[s]." Baetens, 777 F.2d 1160. Baetens' strict adherence to the "plain and unambiguous language" of the statute (id. at 1164) is both the majority view and the more current view. See Fazi, 102 T.C. No. 31 (following Baetens and reviewing other cases). But see Greenwald v. Commissioner, 366 F.2d 538 (2d Cir. 1966) (reaching opposite result from Baetens). See generally 17 Standard Federal Tax
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disqualified because of improper discrimination among employees and similar defects, not because of the source of funds in those accounts. Baetens, 777 F.2d at 1161-62. As for the New Accounts, Baetens did not discuss whether the attempted rollover disqualified them. Id., passim. See generally Fazi v. C.I.R., 102 T.C. 695 (U.S. Tax Ct. 1994) (explaining Baetens).[11]

In other words, Baetens never reached the issue raised by the Trustee in this case: whether the Vanguard accounts are disqualified because they were at least partly funded from a non-qualified plan or source – Debtor's family. On that issue, the starting point is Revenue Code Section 408(a)(5), which states that the "governing instrument" creating an IRA must provide that assets of the account "will not be commingled with other property ...." 26 U.S.C. § 408(a)(5). See also 26 C.F.R. § 1.408-2(b)(5). The Trustee does not allege that the "governing instrument[s]" for the Home Savings Account or the Vanguard accounts lacked provisions barring commingling. Therefore, Debtor's IRAs qualify under the literal words of the statute.

Of course, the operation of Debtors' IRA accounts involved commingling of funds from Debtor and her family. Moreover, there is authority that "[t]o gain the tax benefits of qualification,

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[10](...continued)
Reporter ¶¶ 18,217A.22 and 18,922.16 (CCH 2001) (citing cases disagreeing on effects of commingling and disqualification).

[11] But cf. In re Groff, 234 B.R. 153, 155 (Bankr. M.D. Fla. 1999) (stating, without analysis, that Baetens holds "that an IRA is not tax exempt, even if it is otherwise qualified under the Internal Revenue Code, if the funds in the IRA were transferred from a non-qualified plan") (dicta because court found that trustee had not shown that funds were transferred from a non-qualified plan).

plans must satisfy § 401(a) in their operation as well as in their terms." Ludden v. C.I.R., 620 F.2d 700, 701-702 (9th Cir. 1980) (emphasis added) ("Ludden II"), affirming Ludden v. Commissioner, 68 T.C. 826 (1977) ("Ludden I"). However, Ludden II is distinguishable for three reasons.

First, Ludden II did not involve non-qualified contributions. It involved non-qualified pension and profit-sharing plans that violated the Revenue Code by discriminating "in favor of officers/shareholders/highly compensated employees." Ludden II, 620 F.2d at 702. The distinction is significant because the statute itself distinguishes at least one type of non-qualified contributions – "excess contributions." Commingling excess contributions and other funds does not necessarily disqualify the entire IRA even though such commingling violates Revenue Code Section 408(a)(1) "in operation." Rather, the excess contribution is generally subject to penalties and taxation. See 26 U.S.C. § 408(d)(5); 26 C.F.R. § 1.408-4(c)(4).[12] See also Buzzetta Construction Corp. v. C.I.R., 92 T.C. 641 (U.S. Tax Ct. 1989) (excess contributions to profit sharing plan, governed by comparable regulations, were "material" and therefore IRS did not abuse its discretion in disqualifying plan). The contributions by Debtors' family, apart from Debtor's own contributions, are much more analogous to "excess contributions" than to the plan defect in Ludden II. See 17 Standard Federal Tax Reporter ¶ 18,922.0282 (CCH 2001) (giving example where employer's contribution was non-qualifying because employee had already contributed maximum amount

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[12] The court does not address whether Debtor, or the estate, might have such tax liability or penalties.

for the year).[13]

Second, the rule in Ludden II is not inflexible: the Internal Revenue Service has considerable discretion to allow the taxpayer to make corrections. Ludden II, 620 F.2d at 702; Buzzetta, 92 T.C. at 644 and 646-653 (reciting earlier accommodations by IRS); Lansons, Inc. v. Commissioner, 69 T.C. 773, 787 n.10 (1978) (finding abuse of discretion), aff'd, 622 F.2d 774 (5th Cir. 1980). The Buzzetta court explained that "letter perfect" administration of a retirement plan is not required, and when "deviation from the terms of the plan results in no harm to anyone and is voluntarily corrected by the parties themselves, it might be that the deviation would not be sufficiently substantial to disqualify the plan." Buzzetta, 92 T.C. at 650, quoting Ludden I, 68 T.C. at 832-833, and citing Ludden II, 620 F.2d at 702. The Buzzetta court focused on whether the error was "material," and explicitly distinguished cases involving "funding defects, as contrasted to discriminatory coverage provisions." Buzzetta, 92 T.C. at 651. In this case the Trustee has not suggested any "harm to anyone," nor any reason why

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[13] In the analogous context of rollovers into employee annuities and qualified pension, profit-sharing and stock bonus plans, the regulations provide that an invalid rollover will be treated as a valid rollover, "for purposes of applying the qualification requirements of [Revenue Code] section 401(a) or 403(a) to the receiving plan," if the plan administrator of the receiving plan reasonably concludes that the contribution is a valid rollover contribution when it is received, and if the invalid rollover contribution, plus any earnings attributable thereto, is distributed to the employee within a reasonable time after any determination that the rollover was not valid. 26 C.F.R. 1.401(a)(31)-1 (question and answer no. 14). This safe-harbor provision is consistent with the court's conclusion that non-qualifying contributions under Section 408(a) do not necessarily disqualify the entire IRA.

Debtor and her family could not voluntarily correct the "funding defects" by removing any non-qualifying funds from Debtor's IRAs.

Third, Ludden II is distinguishable because this case involves exemptions, not taxes. The exemptions in CCP Section 703.140(b)(10)(E) do not slavishly follow tax law. See Rawlinson, 209 B.R. 502-505 (discussing whether IRAs are sufficiently "similar" to other plans and contracts listed in Section 703.140(b)(10)(E) to be exempt).

For all of the above reasons, the Trustee has not carried her burden of showing that Debtor's entire IRAs are disqualified simply because they were funded in part by Debtor's family. Therefore, Debtor may exempt at least the $2,000.00 she actually contributed to her IRAs, and the earnings thereon.

4. Debtor is Entitled to Her "Wildcard" Exemption

Debtor can exempt additional amounts using her "wildcard" exemption under CCP Section 703.140(b)(1) and (5). That exemption amounts to $15,800 and Debtor's second amended Schedule C divides this figure among three assets: shares of stock estimated at $250.00, a mutual fund listed at $2,714.00, and $12,000.00 for a "Vanguard Group" IRA (presumably including both Vanguard I and Vanguard II).[14] The Trustee has not objected to this "wildcard" exemption, and therefore Debtor may add this exemption to her $2,000.00 exemption and the earnings thereon.

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[14] The sum of these exempted amounts is only $14,964.00, possibly because Debtor used an estimated value for her shares of stock. No party has objected to Debtor's estimated value, and she may amend her Schedule C, without penalty, to increase the total to exactly $15,800.00.

V. CONCLUSION

Debtor will have 30 days from the date of entry of this Memorandum Decision in which to file and serve on the Trustee her amended schedules increasing her total "wildcard" exemption to $15,800.00, clarifying what portion of that exemption is applied to Vanguard I and what portion to Vanguard II, and showing the total exemption under CCP § 703.140(b)(10)(E) based on her $2,000.00 contribution and the earnings thereon. Debtor shall simultaneously file and serve a declaration showing how the earnings on such $2,000.00 were calculated, and a proposed order and separate judgment as set forth in B.L.R. 9021-1(c). The Trustee shall then have 14 days in which to object to Debtor's calculations. Depending on the nature of those objections, if any, the Court will either enter a separate order and judgment granting in part and overruling in part the Trustee's current objections in accordance with this Memorandum Decision or take other appropriate measures.

Dated: March 12, 2001

Dennis Montali
United States Bankruptcy Judge